THE FT YEAR IN FINANCE

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How gamblers broke the banks

Lionel Barber, editor of the Financial Times, describes a year of turmoil through the FT's pages

Journalism, so the adage goes, is the first draft of history. In 2008, the *Financial Times* had a once-in-a-lifetime opportunity to report, analyse and comment on the most serious financial crisis since the Great Crash of 1929. Here was a global story whose tentacles spread from the US sub-prime mortgage market to the City of London, Iceland, Russian oligarchs, Dubai property barons and numerous other actors. It was a story tailor-made for the FT.

The following articles are a selection of the best of the FT's coverage over the past year. Inevitably, there are gaps. There is no space, for example, for our groundbreaking reporting on the credit ratings agencies and the failure of computer modelling. The aim of this special report is to offer readers an unfolding narrative, as well as a broader perspective on a crisis which shook the western model of market capitalism to its foundations.

The opening commentary by George Soros, the financier and philanthropist, sets the scene. Writing in January, Soros argued that the financial crisis is very different from other crises which have erupted at intervals since the end of the second world war. "[It] marks the end of an era of credit expansion based on the dollar as the international reserve currency." As such, it signals "the culmination of a super-boom that has lasted more than 60 years".

Soros's article provides a useful antidote to those commentators who too easily laid the blame for the crisis on lax regulation of sophisticated financial products. Its origins may indeed go back to sub-prime mortgage lending in the US. But sub-prime mortgages – loans to high-risk borrowers seeking a toehold on the residential property ladder – were merely symptoms of a larger problem: global imbalances, in particular a highly indebted US which sucked up the savings of the rest of the world and consumed more than it produced.

Martin Wolf, the FT's chief economics commentator, has long warned of the threat posed by global imbalances to the world economy. These imbalances include not just the US, but also China's huge current account surplus conveniently invested in US Treasuries. In late February, Wolf showed he was alert to the scale of the crisis, warning that the US faced "the Mother of all Meltdowns". He was clear, too, that the banking system would require a bail-out. And he was spot-on with his strictures to policymakers: the crisis could be managed provided the US acted quickly and others followed suit to sustain domestic demand. This holds even truer today.

In hindsight, the late spring and summer were the calm before the September storm. Equity markets recovered ground and oil continued its dizzy rise. Ironically, in the light of the burst of rate cutting which was soon to follow, central bankers were still worried about inflationary pressures. Niall Ferguson, the author, historian and FT contributing editor, struck a more cautionary note in August. He warned that the local squall in the US could easily turn into a global tempest with profound consequences for economic growth.

In a devastating commentary in September, David Blake, an asset manager and former Goldman Sachs analyst, pointed a finger at Alan Greenspan, long feted as the doyen of central bankers and architect of global prosperity during his 18 years at the Federal Reserve. The Greenspan Fed's policy of low interest rates was not to blame, says Blake, because the US needed low interest rates to avoid a severe recession. "Where Mr Greenspan bears responsibility is his role in ensuring that the era of cheap interest rates created a speculative bubble."

Blake identifies two fatal lapses in the late 1990s: the failure to prick the dotcom equity bubble and the Fed chairman's opposition to regulation of over-the-counter derivatives which formed the bulk of counterparty risk in the ensuing explosion of credit. He says: "To create one bubble may be seen as a misfortune; to create two looks like carelessness. Yet that is exactly what the Greenspan Fed did."

> It raises one of the most tantalising questions of the year: were the US authorities, notably Hank Paulson, right to let Lehman go under?

Another warning voice was that of Gillian Tett, the FT's award-winning capital markets editor. For more than two years Tett, who has a PhD in social anthropology, had pointed to the risks in the sophisticated debt instruments known as credit derivatives. In September 2007, well before before the collapse of Lehman Brothers, Tett identified the heart of the problem. "Although it has been taken as self-evident in recent years that the financial system grows stronger if banks spread their credit risks, some are starting to refine that view... Bankers had become adept at removing credit risk from banks' balance sheets, either by selling the loan directly to outside investors or, more usually, by turning loans into new securities such as bonds and then selling them on the capital markets."

In October 2008, Tett assessed the British authorities' record in the face of the subsequent banking meltdown. After much Bertie Woosterish bumbling, the government announced a £400bn rescue package which recapitalised the banks, drawing lessons from earlier crises in Japan and Sweden. "Finally – albeit belatedly – they have got something right."

Samuel Brittan, the renowned FT economics commentator, takes a philosphical approach in a discourse on what he describes as competitive capitalism. His conclusion at the end of an elegant discussion of asset markets and their destabilising role in the financial system is typically succinct: "We need to be reminded of the dictum of Keynes that 'money will not manage itself'. That goes for credit too."

For a switch in pace, readers should turn to the account of the downfall of Lehman Brothers, the 158-year-old Wall Street investment bank. Written by the FT's banking teams in New York and London, the narrative examines the last months of Dick "the gorilla" Fuld, the former bond trader who ran the bank for 15 years. It is a story of management hubris and excessive risk-taking and it raises one of the most tantalising questions of the year: were the US authorities, notably Hank Paulson, US Treasury secretary, right to let Lehman go under?

In November, Queen Elizabeth II asked another pressing question about the global financial crisis: "Why did no one see this coming? Chris Giles, the FT's economics editor, examines the record of the world's pre-eminent economists. His conclusion: many saw a piece of the jigsaw but very few practitioners of the dismal science covered themselves in glory.

Two commentaries offer a broader political perspective. Martin Wolf looks ahead to post-crisis construction and the need for a regulatory overhaul as substantial as the 1944 Bretton Woods agreement. Philip Stephens concludes that the crisis has indeed produced the outlines of a new geopolitical order, not necessarily to the advantage of the US.

These are necessarily preliminary conclusions. In the New Year, a new US president, Barack Obama, will have his say. The world – and the FT – will be watching.

Worst financial crisis in 60 years marks end of an era

By George Soros
Published Jan 22 2008

The current financial crisis was precipitated by a bubble in the US housing market. In some ways it resembles other crises that have occurred since the second world war at intervals ranging from four to 10 years.

However, there is a profound difference: the current crisis marks the end of an era of credit expansion based on the dollar as the international reserve currency. The periodic crises were part of a larger boom-bust process. The current crisis is the culmination of a super-boom that has lasted for more than 60 years.

Boom-bust processes usually revolve around credit and always involve a bias or misconception. This is usually a failure to recognise a reflexive, circular connection between the willingness to lend and the value of the collateral. Ease of credit generates demand that pushes up the value of property, which increases the amount of credit available. A bubble starts when people buy houses in the expectation that they can refinance their mortgages at a profit. The recent US housing boom is a case in point.

The 60-year super-boom is a more complicated case.

Every time the credit expansion ran into trouble the financial authorities intervened, injecting liquidity and finding other ways to stimulate the economy. That created a system of asymmetric incentives also known as moral hazard, which encouraged ever greater credit expansion. It was so successful that people came to believe in what former US president Ronald Reagan called the magic of the marketplace and I call market fundamentalism.

Fundamentalists believe that markets tend towards equilibrium and the common interest is best served by allowing participants to pursue their self-interest. It is an obvious misconception, because it was the intervention of the authorities that prevented financial markets from breaking down, not the markets But market fundamentalism emerged as the dominant ideology in the 1980s, when financial markets started to become globalised and the US started to run a current account deficit.

Globalisation allowed the US to suck up the savings of the rest of the world and consume more than it produced. The US current account deficit reached 6.2 per cent of gross national product in 2006. The financial markets encouraged consumers to borrow by introducing ever more sophisticated instruments and more generous terms. The authorities aided and abetted the process by intervening whenever the global financial system was at risk. Since 1980, regulations have been progressively relaxed until they have practically disappeared.

The super-boom got out of hand when the new products became so complicated that the authorities could no longer calculate the risks and started relying on the risk management methods of the banks themselves. Similarly, the rating agencies relied on information from originators of synthetic products. It was a shocking abdication of responsibility.

Everything that could go wrong did. What started with subprime mortgages spread to all collateralised debt obligations, endangered municipal and mortgage insurance and reinsurance companies and threatened to unravel the multi-trillion-dollar credit default swap market. Investment banks' commitments to leveraged buyouts became liabilities. Market-neutral hedge funds turned out not to be market-neutral and had to be unwound. The asset-backed commercial paper market came to a standstill and the special investment vehicles set up by banks to get mortgages off their balance sheets could no longer get outside financing. The final blow came when interbank lending, which is at the heart of the financial system, was disrupted because banks had to husband their resources and could not trust their counterparties. The central banks had to inject an unprecedented amount of money and extend credit on an unprecedented range of securities to a broader range of institutions than ever before. That made the crisis more severe than any since the second world war.

Video: Soros at Davos

The financier speaks to **Chrystia Freeland**, the FT's US managing editor **www.ft.com/soros-davos**

Credit expansion must now be followed by a period of contraction, because some of the new credit instruments and practices are unsound and unsustainable. The ability of the financial authorities to stimulate the economy is constrained by the unwillingness of the rest of the world to accumulate additional dollar reserves. Until recently, investors were hoping that the US Federal Reserve would do whatever it takes to avoid a recession, because that is what it did on previous occasions. Now they will have to realise that the Fed may no longer be in a position to do so. With oil, food and other commodities firm, and the renminbi appreciating somewhat faster, the Fed also has to worry about inflation. If federal funds were lowered beyond a certain point, the dollar would come under renewed pressure and long-term bonds would actually go up in yield. At that point the ability of the Fed to stimulate the economy comes to an end.

Although a recession in the developed world is now more or less inevitable, China, India and some of the oil-producing countries are in a very strong countertrend. So the current financial crisis is less likely to cause a global recession than a radical realignment of the global economy, with a relative decline of the US and the rise of China and other developing countries.

The danger is that the resulting political tensions, including US protectionism, may disrupt the global economy and plunge the world into recession or worse.

The writer is chairman of Soros Fund Management.

Inside this issue

How a local squall might become a global tempest

By Niall Ferguson
Published August 8 2008

The phrase "perfect storm" has been trotted out once too often to characterise the past year's financial crisis. Yet the real perfect storm may still lie ahead.

Fans of the George Clooney film will recall that the perfect storm was caused by the convergence of a hurricane off the Atlantic seaboard, an area of low pressure south of Nova Scotia and a cold front swooping down from Canada. Result: howling winds, vast waves and the loss of at least one boatload of Gloucester fishermen.

One year after the onset of the financial crisis we are still calling the "credit crunch", could we be witnessing a similar catastrophic convergence, as the slow-moving hurricane of a US banking crisis hits first a commodity price rise and then a global slowdown?

Until now this crisis has been primarily a US affair, albeit with collateral damage (literally) on the balance sheets of many European banks. The crisis had its origins in a US real estate bubble fuelled by easy money and lax lending standards. Ordinary Americans gave up saving, pinning their hopes for the financial future on a leveraged play on the real estate market. In barely a decade, household sector indebtedness surged from 90 per cent to 133 per cent of disposable personal income. At its peak in August 2004, annual house price inflation exceeded 20 per cent.

With the inevitable bursting of that bubble, the process has gone into reverse. House prices are falling at an annual rate of 15 per cent. The catalyst for the bust was defaults by subprime borrowers but, as prices continue to fall, less marginal homeowners are coming under pressure. Credit Suisse recently forecast that by the time the crisis is over as many as 6.5m loans will have fallen into foreclosure – more than one in 10 of all US mortgages.

A property crash like this has not been seen since the Great Depression. The difference is that the monetary and fiscal authorities have done everything in their power to prevent a repeat of what Milton Friedman and Anna Schwartz dubbed "the great contraction" between 1929 and 1933. What happened then was that falling asset prices caused thousands of banks to fail, while the Federal Reserve did almost nothing to mitigate (and a good deal to accentuate) the consequent monetary implosion. Under Ben Bernanke's historically informed leadership, the Fed has done the exact opposite, slashing interest rates and, more importantly, targeting liquidity at banks through the discount window and new term auction facilities.

This has so far averted a full-scale banking crisis but it is important not to overstate the achievement. Most kinds of mortgage-backed securities have not significantly recovered from the initial crisis, while the market for collateralised debt obligations is all but dead. After writedowns in excess of $400bn and capital injections of about $300bn, many banks still look fragile. Shares in at least 40 US banks are down 70 per cent or more. We know the US Treasury will intervene to avert the collapse of institutions it deems too big (or important) to fail: witness the brokered sale of Bear Stearns and the hasty bail-out of Fannie Mae and Freddie Mac. But many second-rank banks seem certain to follow Indymac into oblivion.

Call it a partially contained banking crisis, then. The impact on the rest of the economy is still bound to be serious. Before the crunch, credit extension in the US was growing at 4 per cent a year; now the figure is minus 7 per cent. The evidence is mounting that the US economy is on the brink of recession. Business bankruptcies are up, payrolls are down and corporate earnings have slumped. And, of course, as things get tough on Main Street there will be a second wave of financial problems, beginning with corporate defaults and commercial real estate blow-ups.

> The EU's economy is more than five times larger than China's. It also matters more to US exporters

The question is whether or not this American hurricane is about to run into two other macroeconomic weather systems. Up until now the global impact of the crisis has been limited. Indeed, strong global growth has been the main reason the US recession did not start sooner. With the dollar weakened as an indirect consequence of the Fed's open-handed lending policy, US exports have surged. According to Morgan Stanley, net exports accounted for all but 30 basis points of the 1.8 per cent growth in US output over the past year.

The downside of this, however, was a rise in commodity prices as strong Asian demand coincided with a depreciating dollar. For a time, this coincidence of a US slowdown and soaring oil prices revived memories of 1970s stagflation. But now a new and colder front is crossing the macroeconomic weather map: the prospect of a global slowdown.

Admittedly the forecasts do not sound too alarming. A reduction in global growth from 4.1 per cent this year to 3.6 per cent next year could positively help damp inflationary pressures. Optimists such as Jim O'Neill at Goldman Sachs celebrate the "decoupling" of China from the US, pointing out that nearly all China's growth is accounted for by domestic demand, not exports.

Yet there are reasons to be less cheerful. First, Europe has clearly not decoupled from America. Indeed, partly because of the strength of the euro, the eurozone is now growing more slowly than the US. And remember: the European Union's economy is still more than five times larger than China's. It also matters a great deal more to US exporters.

Second, the commodity price rise has generated inflationary pressures in many emerging markets that will not recede overnight. According to Joachim Fels of Morgan Stanley, 50 of the 190 countries in the world currently have double-digit inflation. The World Bank has identified 33 countries where high food prices have generated civil unrest.

Third, decoupling is not a cause for celebration if, on closer inspection, it is a synonym for deglobalisation. The growth of the world economy since 1980 has owed much to lower trade barriers. Unfortunately, the recent breakdown of the Doha round of global trade talks sent a worrying signal that commitment to free trade is weakening. It was troubling, too, how many governments responded to the rice price jump with export restrictions.

One year on, what began as a US crisis is fast becoming a world crisis. Small wonder only a handful of global equity markets are in positive territory relative to August 2007, while more than half have declined by between 10 and 40 per cent. The US slowdown will also affect many emerging markets less reliant on exports than China. At the same time, the global slowdown is about to kick away the last prop keeping the US recession at bay. No, this is not the Great Depression 2.0; the Fed and the Treasury are seeing to that. But, as in the 1930s, the critical phase is not the US phase. When the crisis goes global the term "credit crunch" will no longer suffice.

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US risks mother of all meltdowns

By Martin Wolf
Published Feb 19 2008

"I would tell audiences that we were facing not a bubble but a froth – lots of small, local bubbles that never grew to a scale that could threaten the health of the overall economy." Alan Greenspan, The Age of Turbulence.

That used to be Mr Greenspan's view of the US housing bubble. He was wrong, alas. So how bad might this downturn get? To answer this question we should ask a true bear. My favourite one is Nouriel Roubini of New York University's Stern School of Business, founder of RGE monitor.

Recently, Professor Roubini's scenarios have been dire enough to make the flesh creep. He first predicted a US recession in July 2006*. At that time, his view was extremely controversial. It is so no longer. Now he states that there is "a rising probability of a 'catastrophic' financial and economic outcome"**. The characteristics of this scenario are, he argues: "A vicious circle where a deep recession makes the financial losses more severe and where, in turn, large and growing financial losses and a financial meltdown make the recession even more severe."

Prof Roubini is even fonder of lists than I am. Here are his 12 – yes, 12 – steps to financial disaster.

Step one is the worst housing recession in US history. House prices will, he says, fall by 20 to 30 per cent from their peak, which would wipe out between $4,000bn and $6,000bn in household wealth. Ten million households will end up with negative equity so with a huge incentive to put the house keys in the post and depart for greener fields. Many more home-builders will be bankrupted.

Step two would be further losses, beyond the $250bn-$300bn now estimated, for subprime mortgages. About 60 per cent of all mortgage origination between 2005 and 2007 had "reckless or toxic features", argues Prof Roubini. Goldman Sachs estimates mortgage losses at $400bn. But if home prices fell by more than 20 per cent, losses would be bigger. That would further impair the banks' ability to offer credit.

Step three would be big losses on unsecured consumer debt: credit cards, auto loans, student loans and so forth. The "credit crunch" would then spread from mortgages to a wide range of consumer credit.

Step four would be the downgrading of the monoline insurers, which do not deserve the AAA rating on which their business depends. A further $150bn writedown of asset-backed securities would then ensue.

Step five would be the meltdown of the commercial property market, while step six would be bankruptcy of a large bank.

Step seven would be big losses on reckless leveraged buy-outs. Hundreds of billions of dollars of such loans are now stuck on the balance sheets of financial institutions.

Step eight would be a wave of corporate defaults. On average, US companies are in decent shape, but a "fat tail" of companies has low profitability and heavy debt. Such defaults would spread losses in "credit default swaps", which insure such debt. The losses could be $250bn. Some insurers might go bankrupt.

Step nine would be a meltdown in the "shadow financial system". Dealing with the distress of hedge funds will be made more difficult by the fact that they have no direct access to lending from central banks.

Step 10 would be a further collapse in stock prices. Failures of hedge funds, margin calls and shorting could lead to cascading falls in prices.

Step 11 would be a drying-up of liquidity in financial markets including interbank and money markets. Behind this would be a jump in concerns about solvency.

Step 12 would be "a vicious circle of losses, capital reduction, credit contraction, forced liquidation and fire sales of assets at below fundamental prices".

These, then, are 12 steps to meltdown. In all, argues Prof Roubini: "Total losses in the financial system will add up to more than $1,000bn and the economic recession will become deeper, more protracted and severe."

This, he suggests, is the "nightmare scenario" keeping Ben Bernanke and colleagues at the US Federal Reserve awake.

It explains why, having failed to appreciate the dangers for so long, the Fed has reduced rates by 200 basis points this year. This is insurance against a financial meltdown.

> This is not to suggest that there are no ways out. Unfortunately, they are poisonous ones

Is this kind of scenario at least plausible? It is. Furthermore, we can be confident that it would end all stories about "decoupling". If it lasts six quarters, as Prof Roubini warns, offsetting policy action in the rest of the world would be too little, too late.

Can the Fed head this danger off? In a subsequent piece, Prof Roubini gives eight reasons why it cannot***. (He really loves lists!) These are, in brief: US monetary easing is constrained by risks to the dollar and inflation; aggressive easing deals only with illiquidity, not insolvency; the monoline insurers will lose their credit ratings, with dire consequences; overall losses will be too large for sovereign wealth funds to deal with; public intervention is too small to stabilise housing losses; the Fed cannot address the problems of the shadow financial system; regulators cannot find a good middle way between transparency over losses and regulatory forbearance, both of which are needed; and, finally, the transactions-oriented financial system is itself in deep crisis.

The risks are indeed high and the ability of the authorities to deal with them more limited than most people hope. This is not to suggest that there are no ways out. Unfortunately, they are poisonous ones. In the last resort, governments resolve financial crises. Rescues can occur via overt government assumption of bad debt, inflation, or both. Japan chose the first, much to the distaste of its ministry of finance. But Japan is a creditor country whose savers have confidence in the solvency of their government. The US is a debtor. It must keep the trust of foreigners. Should it fail, the inflationary solution becomes probable. This explains why gold costs $920 an ounce.

The connection between the bursting of the housing bubble and the fragility of the financial system has created huge dangers, for the US and the rest of the world. The US public sector is now coming to the rescue, led by the Fed. In the end, they will succeed. But the journey is likely to be wretchedly uncomfortable.

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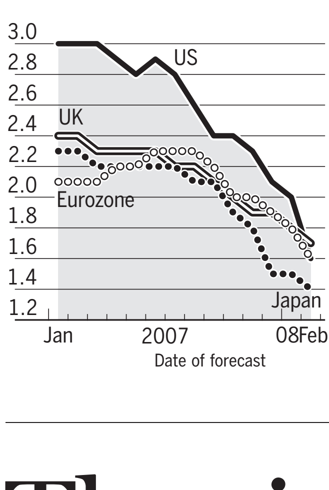
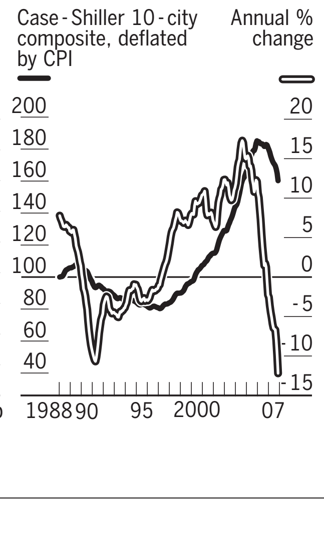
**A Coming Recession in the US Economy? July 17 2006, www.rgemonitor.com. **The Rising Risk of a Systemic Financial Meltdown, Feb 5 2008. ***Can the Fed and Policy Makers Avoid a Systemic Financial Meltdown? Most Likely Not, Feb 8 2008.*

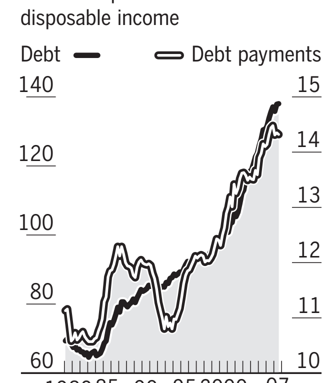
Forecasts for GDP growth in 2008
Annual % change in real GDP



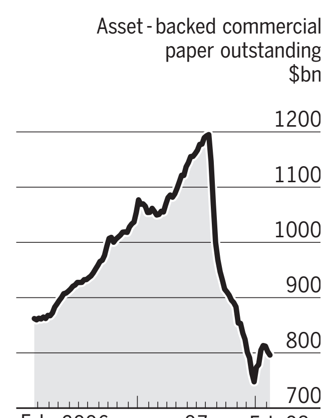
US real house prices



US household debt and debt service
As a % of personal disposable income



US commercial paper



Sources: Consensus Economics; Thomson Datastream; Federal Reserve

The sins of Greenspan have come back to haunt us

By David Blake
Published Sept 19 2008

Back in 2002, when his reputation as "The Man Who Saved the World" was at its peak, Alan Greenspan, former chairman of the Federal Reserve, travelled to Britain to pick up his knighthood. His biggest fan, Gordon Brown, now prime minister, had ensured that the citation said it was being awarded for promoting "economic stability".

During his trip, Mr Greenspan visited the Bank of England's monetary policy committee. He told them that the US financial system had been resilient amid the bursting of the internet bubble. Share prices had halved and there had been massive bond defaults, but no big bank collapses. Mr Greenspan lauded the fact that risk had been spread, using complex derivative instruments. One of the MPC members asked: how could this be? Someone must have lost all that money; who was it? A look of quiet satisfaction came across Mr Greenspan's face as he answered: "European insurance companies".

Six years later, AIG, the largest US insurance company, has in effect been nationalised to stop it blowing up the financial world. The US has nationalised the core of its mortgage industry and the government has become the arbiter of which financial companies should survive or die.

Financial markets have an enormous capacity for flexibility, but market participants need to be sure that there are rules, and a referee who is willing to impose them.

Permanent damage has been done to the financial system, despite the extraordinary measures of Messrs Hank Paulson, the US Treasury secretary, and Ben Bernanke, the Fed chairman, to address the problems that stem from the actions of their predecessors. As Mr Paulson has suggested, he is playing a hand dealt by others.

Many blame the Greenspan Fed for this mess. They are right, but not for the reason often cited. It is unfair to say low interest rates are to blame. In the past decade, there is no evidence that the US suffered from excessive growth leading to inflation. The economy needed low interest rates and a fiscal stimulus to avoid a severe recession. The Fed was right to do its bit.

Where Mr Greenspan bears responsibility is his role in ensuring that the era of cheap interest rates created a speculative bubble. He cannot claim he was not warned of the risks. Take two incidents from the 1990s. The first came before he made his 1996 speech referring to "irrational exuberance". In a Federal Open Market Committee meeting, he conceded there was an equity bubble but declined to do anything about it. He admitted that proposals for tightening the margin requirement, which people need to hold against equity positions, would be effective: "I guarantee that if you want to get rid of the bubble, whatever it is, that will do it." It seems odd that since then, in defending the Fed's inaction, he has claimed in three speeches that tightening margins would not have worked.

The second incident stems from spring 1998 when the head of the Commodity Futures Trading Commission expressed concern about the massive increase in over-the-counter derivatives. These have been at the heart of the counter-party risk in the crisis. Mr Greenspan suggested new regulation risked disrupting the capital markets.

> Greenspan did not just stand aside. He said repeatedly that housing was a safe investment because prices do not fall

At the turn of the millennium, with no move to tighten margin requirements, a feedback loop sent share prices into orbit. As prices rose, more brokers were willing to lend to buy more shares. As share prices went up the buying continued, until the bubble burst. To create one bubble may be seen as a misfortune; to create two looks like carelessness. Yet that is exactly what the Greenspan Fed did.

Bruised by stock market losses, Americans bought houses. The mortgage industry used securitised bonds to ensure that the people who initiated the mortgage did not worry about getting paid back; risk was packaged and sold to others. This time Mr Greenspan did not just stand aside. He said repeatedly that housing was a safe investment because prices do not fall. Home owners could wait out any downturn. Is it any surprise that so many people thought that if the world's financial genius held this view it must be all right?

Even as things went completely wild, Mr Greenspan dismissed those who warned that a new bubble was emerging. It was just a case of a little "froth" in a few areas. Later, after waiting until 2007, two years after he left office, he conceded that "froth" had been his euphemism for "bubble". He told the Financial Times: "All the froth bubbles add up to an aggregate bubble."

This time, as with the equity bubble, the mistake was not to set interest rates too low; it was to stand back as wildly imprudent policies were pursued by mortgage lenders. Indeed, any lender would have been encouraged by his words in April 2005: "Where once more-marginal applicants would simply have been denied credit, lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately. These improvements have led to rapid growth in subprime mortgage lending." Well, he was right about the rapid growth in subprime lending.

Mr Greenspan was in charge of supervising and regulating much of the banking industry for two decades. The Fed says it is responsible for ensuring "safe and sound banking practices". It is right that other regulators should have stepped in, too – the US regulatory structure has not kept pace with market changes. But given the Fed's institutional importance and Mr Greenspan's personal stature, does anyone doubt that the Fed could have used its limited powers to ensure a closer examination of what was going on? Mr Greenspan realises that something big has happened and describes it as a "once in 100 years" event. But then, you do not get Alan Greenspans coming along every day.

The writer is an executive in an asset management company. He writes in a personal capacity.

A shift from bumbling to sensible policy

By Gillian Tett
Published Oct 9 2008

During much of the past year, British financial authorities have looked like Bertie Wooster-style, bumbling amateurs in the face of the banking meltdown. Now, finally – albeit belatedly – they have got something right.

Alistair Darling, chancellor of the exchequer, on October 8 announced that the government would spend up to £400bn underpinning the banks. The only thing more startling than those dazzling zeroes is that Mr Darling is now overseeing a policy package that is arguably more sensible than anything else emanating from the western world.

This package suggests that British mandarins have finally learnt to draw sensible lessons from the past, most notably from the 1990s crises in Japan and Sweden. More striking still, these moves could also provide pointers for how the US authorities could improve their own policies.

There are at least three reasons to cheer. The first is that the UK government has acknowledged something the Americans remain reluctant to admit: that when a banking crisis is this bad, it makes more sense to recapitalise banks by buying preference shares than by purchasing their duff assets.

That does not necessarily mean that a "Tarp" – the scheme the US is creating to purchase toxic debt – is a bad idea. On the contrary, if the Tarp creates a liquid market for mortgage debt and removes rot from bank books, all financial players will benefit – including those in London. This puts British authorities in an unusually favourable position in formulating their own policies.

However, the problem with the Tarp is that the toxic assets are so fiendishly complex that they cannot be easily valued or traded. Even in good times, it can take a computer several days to price complex collateralised debt obligations. That creates daunting logistical obstacles for a Tarp, which could delay or blur the balance sheet benefits.

Putting money directly into the banks, by contrast, is a fast and transparent way to help them. Moreover, it worked relatively well when it was employed by Japan and Sweden a decade ago, in tandem with various initiatives to purchase toxic assets. Better still, while both Sweden and Japan badly underestimated the scale of their crisis when it started, once they finally produced a hefty bail-out plan, they eventually recouped most of their investment.

> The problem is that the toxic assets are so fiendishly complex that they cannot be easily valued or traded

A second point of cheer is that the British now also seem ready to take other steps to get credit and money markets moving again. The most eye-catching element of this revolves around injections into the money markets. But what is as important is a pledge that debt issued by banks will be protected from default.

That may sound arcane. However, it is crucial. Until last month, European and US investors assumed that bonds issued by large banks were safe, since they had been protected in previous decades. But the manner of Lehman Brothers' collapse shattered that belief in a manner that sparked a catastrophic chain of fear.

The Federal Reserve's apparent failure to anticipate that shock represents one of its biggest single policy mistakes. The October 8 announcement suggests the UK authorities have no intention of repeating this disastrous error. So much the better.

However, the third reason for cheer lies not in arcane finance – but in sociology. Right now many voters are understandably furious with bankers. No wonder. When the banking crisis hit Japan a decade ago, bankers bowed to show their public remorse; this time, however, barely a single western banker has even said "sorry".

Now, there is no guarantee that the British government can assuage this anger; but on October 8 it did at least promise to impose more "discipline" on bankers. That may turn out to be mere window dressing; but it is more than anything offered by Washington so far.

Of course, none of this guarantees that the UK can end its banking woes, let alone avoid a recession. Unlike the Japanese and Swedish crises, this one is international. As a result, the fortunes of British finance now depend on more than UK policymaking alone.

But, with a bit of international co-ordination – and a hefty dose of luck – London does now have a chance of stabilising its banking system. The tragedy is that it took so much incompetence and denial – on both sides of the Atlantic – to arrive at this point. If nothing else, the next generation of bankers and financial bureaucrats should be compelled to start their careers by spending time studying financial history books.

Change of view: UK financial authorities' bank rescue package learns from history Daniel Lynch

Capitalism and credit

By Samuel Brittan
Published Sept 11 2008

What does the great credit crunch do to the case for competitive capitalism? Many revisionist left-of-centre politicians not only have risked their careers to make the case for market forces, but have also had to jettison their deepest lifetime convictions. Are they now to stand on their heads and say they have been wrong all along? And if they did so, where would they turn? Even if in the end we suffer no more than an average post-second-world-war recession it will still look like a narrow escape owing to the readiness of leaders such as Hank Paulson, the US Treasury secretary, not merely to jettison free-market principles but to take risks with prudence to bail out US corporate bodies. There will be no "glad confident morning" for free-market principles for a long time to come.

It is for such reasons that I welcome a short and well-written book, *The Origin of Financial Crises* (Harriman House £16.99) by George Cooper, which attempts to relate apparently esoteric financial issues to elementary economic theory. He quotes from Paul Samuelson, author of what was probably the best-selling economics textbook of the 20th century, *Economics: An Introductory Analysis*. Prof Samuelson provides a simple introductory outline of a competitive market system. If there is a flood of new orders for, say, shoes, their price will rise and more pairs will be produced. If there is a glut of tea, its price will be marked down, people will drink more and producers will supply less. "Thus equilibrium of supply and demand will be restored."

Mr Cooper's criticism is reserved for what looks like a throwaway sentence at the end of Samuelson's account. "What is true of the market for consumer goods is also true of markets for factors of production such as labour, land and capital inputs." Mr Cooper concentrates on capital, the market for which he believes is entirely different from that for consumer goods. The crucial distinction I would put slightly differently: between products that are valued for their own sake – "use value" in Marxist jargon – and those that are valued wholly or partly for their future resale value and are therefore prone to bubbles.

Mr Cooper's main contention is that asset markets are peculiarly vulnerable to boom and bust, and are therefore the real destabilising force in the financial system, while central banks concentrate on consumer prices. Something called the efficient markets hypothesis appears and reappears like King Charles's head throughout Mr Cooper's book. This hypothesis blossomed out into the belief that assets are always correctly priced.

I will take Mr Cooper's word that the efficient markets hypothesis lies at the basis of the models prepared by the rocket scientists in the backrooms of banks and hedge funds. And in diluted form it may lie behind the reluctance of modern central banks to act on asset bubbles.

Mr Cooper's most novel doctrine is that investors do not have to be irrational to generate bubbles. They simply do not have the knowledge required by the efficient markets hypothesis. But is not this ignorance an obstacle to the official action on asset prices, which some would like to see supplement and others to replace altogether consumer price targets?

Yet, however difficult it is, the rethink that is likely to follow the credit crunch is bound to make more room for asset prices in central bank objectives even at the cost of some intellectual untidiness.

Readers will not be surprised that Mr Cooper traces present difficulties to the rapid growth of credit encouraged by the Fed's ultra-cheap money policy of a few years ago. Interestingly enough, an International Monetary Fund working paper by Noureddine Krichene shows convincingly that during the years 2003 to 2007 there was no one shock confined to oil or any other commodity but a parallel increase in nearly all commodity prices. During this period consumer prices remained subdued, giving false security.

Now the chickens have come home to roost in that combination of inflation and recession that constitutes such a nightmare for central banks. The IMF author has no doubt that we are seeing "the delayed effect of an overly expansionary monetary policy which led to a vast expansion of all types of credits, irrespective of creditworthiness". I still worry about what the effects of a tighter policy would have been in the face of large Chinese and Organisation of Petroleum Exporting Countries saving surpluses. But it may be that the US could have continued to be a consumer of last resort even without a Fed stimulus.

To return to the broader question about competitive capitalism with which I started. Nothing that has happened suggests that governments are any good at picking winners, that freeing international trade is a bad thing or that consumer choice should be overridden. But we need to be reminded of the dictum of Keynes that "money will not manage itself". That goes for credit too.

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Brinkmanship was not enough to save Lehman

By Henny Sender, Francesco Guerrera, Peter Thal Larsen and Gary Silverman
Published September 15 2008

On May 29 2007, with the clock ticking on one of the greatest global property booms in history, Richard Fuld rolled the dice on the US real estate market one more time.

The odds were not good for the chairman and chief executive of Lehman Brothers investment bank. It had been nearly a year since the US Federal Reserve brought an end to the era of cheap money with a series of interest rate increases that took its overnight lending rate from 1 per cent in June 2003 to 5.25 per cent in June 2006. It had been more than three months since HSBC became the first big global bank to reveal multi-billion-dollar losses on subprime mortgage loans. The credit cycle was turning, as it had so many times before during Mr Fuld's four decades at Lehman. But he still felt lucky.

As a result, Lehman, a bank with a little more than $20bn in equity at the time, joined Tishman Speyer, a developer, and Bank of America to spend $15bn on Archstone-Smith Trust, a property investment company that owned a giant portfolio of apartments in "the most desirable" neighbourhoods of large US cities.

Lehman had its reasons for believing that it could still make money in US property. Blackstone, a private equity firm run by former Lehman executives Steve Schwarzman and Pete Peterson, had just stunned Wall Street by sealing a string of profitable deals to sell several upscale office towers acquired as part of its highly leveraged $36bn buyout of Equity Office Properties a few months previously.

The Archstone deal was also consistent with the high-risk, high-reward culture that had taken root at Lehman. With less capital than rivals such as Goldman Sachs and Morgan Stanley, Lehman was known for punching above its weight and being quicker than others to seize opportunities. Mr Fuld, a former bond trader known to associates as "the gorilla", was the embodiment of this culture. A man of military mien known for his direct management style, he was determined, having re-established the bank's independence from American Express, to return it to the pinnacle of Wall Street.

He almost got there. In the months preceding Archstone, Lehman was worth $60bn and was seen as one of Wall Street's best-run banks. Mr Fuld had also shown himself very much aware of the storms gathering over the financial system. At Lehman's 2006 Christmas party visitors noted his cautious outlook for the year ahead. A month later at last year's World Economic Forum in Davos he talked openly about being "really worried" about the risks posed by property valuations, excess leverage and the rise in oil and commodity prices. "We're taking some money off the table," he said.

But while Mr Fuld may have been aware of danger and prepared to take precautions, within Lehman, as one insider remembers, "the acquisition machine rolled on".

With the benefit of hindsight, the Archstone deal was a sign that Lehman was losing its touch. Just as the deal was being done, an era of wheeling-and-dealing fuelled by mountains of cheap debt was coming to an end. Over at Blackstone, Jon Gray, the group's property chief, was already confessing to associates that the office tower sales the firm had made in April 2007 would have been impossible a month later. Mr Fuld, in other words, had committed the ultimate Wall Street sin – buying at the top of the market.

Archstone was a millstone for Lehman, part of a crippling $30bn-plus in property assets that the bank could not sell and investors could no longer tolerate. The bank's stock market capitalisation crumbled to the point where it stood at $2bn last Friday. By Monday morning it was seeking protection from its creditors.

Lehman on Monday declined to comment but insiders said the bank was hit by a crisis of such virulence that Mr Fuld and other senior executives could have done little to avoid its consequences. While the Archstone deal came near the peak of the property cycle, they added, it did not in itself play a big part in Lehman's demise. Mr Fuld's allies said the chief executive did not disregard risk-management, pointing out that top executives met every Monday, often for several hours, to review the bank's risk practices.

> Lehman thought of itself as the smart, scrappy underdog – not just good at spotting chances but also nimble enough to get out in time

Yet the bet that left Lehman with a massive illiquid property portfolio was hardly out of character for a bank built in the image of its pugnacious 62-year-old chief executive. Mr Fuld was known as a canny operator, leveraging his bank's prowess in the fixed-income markets and its small pile of capital to take big risks and earn bigger returns than larger rivals. Lehman thought of itself as the smart, scrappy underdog – not just good at spotting chances but also nimble enough to get out in time.

It was a formula that was prone to trouble. In 1998, when Wall Street executives and regulators met at the New York Federal Reserve to rescue the Long-Term Capital Management hedge fund, Lehman was allowed to chip in less money than most of its competitors – an acknowledgement that it had problems of its own.

However, Mr Fuld brought Lehman back from the abyss in take-no-prisoners fashion, pushing regulators to clamp down on rumour-mongering and firing up his staff. His inspirational abilities were on display after the September 11 attacks forced Lehman to evacuate its headquarters and relocate to a midtown hotel. There, Mr Fuld addressed his staff like a general going into battle.

With the Fed keeping interest rates low to stave off a recession after the terrorist attacks, Lehman grew rapidly, playing an outsized role in the securitisation market and the leveraged lending businesses – and produced quarter after quarter of record earnings from 2005 to 2007. Mr Fuld was feted as a visionary and paid as such, with Lehman awarding him a $186m 10-year stock award bonus in 2006 – prompting criticism that the investment bank's board of directors had grown too cosy with their chief executive.

But as Lehman grew bigger, signs of internal tensions emerged. In 2004, Mr Fuld picked Joe Gregory, a former commercial paper trader, as president and chief operating officer – effectively his successor.

Mr Gregory personified Lehman's loyal, co-operative culture. But former colleagues say he became obsessed with the administrative processes and recruiting practices, while neglecting risk management.

They also accuse him of ratcheting up the appetite for risk and forcing out executives who disagreed. One of the Lehman bankers who urged caution, former colleagues say, was Mike Gelband, former head of fixed-income, who left in early 2007.

At the time of the Archstone deal and for some months afterwards, Lehman insiders recall few, if any, internal objections. Instead, executives remained so bullish that they congratulated themselves on having picked up Archstone on the cheap. Internal criticism became more common after Mr Gregory helped install Erin Callan as Lehman's chief financial officer in the summer of 2007. A well-regarded investment banker, Ms Callan was widely touted as a rare example of a woman breaking into Wall Street's upper ranks. But some Lehman bankers questioned whether putting a dealmaker in charge of the books was the right move as the subprime mortgage crisis worsened.

Mr Fuld's role in these decisions was hard to pin down because colleagues say he was growing more remote. Mr Fuld spent an increasing amount of time in his mansion in Sun Valley, a ski resort in Idaho that he has used for years to entertain clients, or travelling around the world. "When Dick came over it was like a state visit," says one London-based banker. Some bankers believed, too, that Mr Gregory shielded Mr Fuld from what was going on and discouraged executives from raising criticism or reporting bad news. "Joe was like Dick's bodyguard," says one senior banker.

It could be argued that clearer-eyed commentary on Lehman came from hedge fund managers such as David Einhorn of Greenlight Capital, who repeatedly questioned whether the bank's problems were deeper than many thought. Lehman tried to wave off such criticism but investors drove the bank's shares lower.

Lehman tried to shore up its defences this year, securing a $2bn credit line from its banks on March 14 – the Friday before the Fed-engineered sale of Bear Stearns to JPMorgan Chase. As part of the rescue, the Fed said it was making its borrowing window available to securities firms in a move widely seen on Wall Street as influenced by Mr Fuld, who sat on the board of the New York Fed. Indeed, some bankers referred to the measure as the Save Lehman Act of 2008. If so, it was to provide only a temporary respite.

Lehman's access to the discount window seemed to preclude a Bear-style run on the bank. But Mr Einhorn continued to question the value Lehman assigned to its holdings. Analysts were particularly sceptical about Archstone, arguing that it should be marked down by 30 per cent – in line with comparable property investment companies and the relevant indices. In that case $4bn in bridge equity provided by a Lehman-led bank group – intended to be eventually replaced by funds from other sources – would be at risk.

In June, Lehman stunned the market with a $2.8bn loss. The bank demonstrated its connections in the financial world, however, by also raising $6bn in new capital. Hank Greenberg, the former AIG chief executive, invested through his CV Starr vehicle, along with the state of New Jersey pension fund; Wes Edens, a former Lehman executive and the founder of Fortress Investment Group; and GLG, a hedge fund 20 per cent owned by Lehman.

But for its critics, Lehman's earnings report contained further reasons to worry. Despite the loss, it was marking its Archstone holdings at 85 cents on the dollar – far higher than bearish critics thought appropriate.

What the hedge funds did not know was that Lehman's search for new capital was going international. Before raising $6bn from domestic sources, Lehman had sought an investment from Korea Development Bank, a South Korean state-controlled lender.

Two days after the earnings announcement, Mr Gregory and Ms Callan were ousted, and Bart McDade, previously head of Lehman's equities business, was installed as president. The reshuffle sparked more turmoil inside the bank. Executives who had left, such as Mr Gelband and Alex Kirk, a former fixed-income banker, returned to senior positions. In London, Jeremy Isaacs, a long-serving executive who had overseen Lehman's expansion in Europe and Asia, signalled that he wanted to leave.

In public, Mr Fuld embarked on a crusade to stop what he regarded as a concerted campaign to sink Lehman by a small group of short-sellers. He called on the Securities and Exchange Commission to take action, drawing up a voluminous dossier of "evidence".

The SEC eventually tightened rules outlawing abusive short-selling for Lehman and several other financial groups. But Mr Fuld went further, phoning some Wall Street counterparts to say that he had heard their traders were spreading false rumours about his bank.

But such behind-the-scenes actions only served to confirm the anxieties of Mr Fuld's critics. In late June and early July, he began discussing the possibility of a management buyout and initiated talks with half a dozen private equity firms, with the idea that each would put up about $2bn. Those talks also went nowhere. By August, analysts were anticipating red ink, with JPMorgan predicting a possible $4bn loss. The share price drop accelerated.

> Wall Street titans huddled for hours in an attempt to devise a plan to buy $33bn of commercial assets from Lehman

During the first week of August, Lehman hosted top executives of Korea Development Bank and China's Citic Securities at its New York headquarters for talks on the purchase of a major stake in the bank. Mr Fuld greeted his guests with a show of strength, people familiar with the talks said. Even when he was not in the room, he directed the negotiations, according to one adviser to KDB, and gave out virtually no information about Lehman's holdings. "The Koreans were very receptive," says this person. "But then he [Mr Fuld] tried to change the terms. The deal went away." Lehman has declined to comment on Mr Fuld's role in the talks.

Lehman's insiders argue that KDB never tabled a formal offer and that the prolonged discussions prevented them from seeking other suitors. In their view, Lehman's downfall was so fast that Mr Fuld had little time to look for alternatives.

Lehman did begin talks with potential buyers for all or part of its property book, including Blackstone and Colony Capital, another savvy player in the market. Last week the bank said that it planned to sell its $4bn UK portfolio to private equity group BlackRock – while providing 75 per cent of the financing – but found no takers for other holdings.

It also initiated talks with several parties about its asset management business – its crown jewel, including Neuberger Berman. Carlyle, a private equity firm, was willing to buy the whole thing for about $7bn and give Lehman the right to buy it back, But Lehman held out for a better deal and spurned Carlyle's offer, according to people familiar with the matter.

When Lehman's end did come, it was swift. As Hank Paulson, US Treasury secretary, and Tim Geithner, the president of the New York Fed, summoned the heads of some of the world's largest banks to crisis talks on Friday, it did not take long for them to realise that Lehman was doomed.

Wall Street titans including Lloyd Blankfein of Goldman Sachs, Morgan Stanley's John Mack and Merrill Lynch's John Thain huddled for hours in an attempt to devise a plan to buy $33bn of commercial assets from Lehman. The deal, reminiscent of the LTCM bail-out in 1998, was aimed at facilitating a sale of Lehman to Bank of America or Barclays of the UK.

But there was a snag: neither suitor was prepared to table a bid for Lehman without a government guarantee that would have allowed the bank to continue trading until a takeover was completed. When Mr Paulson indicated that there would be no repeat of the intervention that helped JPMorgan Chase's acquisition of Bear Stearns and enabled the government takeover of Fannie Mae and Freddie Mac, the giant mortgage financiers, Lehman's game was up. Bank of America quickly announced it had entered merger discussions with Merrill Lynch, while Barclays withdrew from the race.

All that Lehman's executives could do was embark on the grim ritual of a bankruptcy filing. It is impossible to say whether the bank could have escaped with its independence intact. Critics point to a string of poor decisions as a sign that Mr Fuld and his team were late to recognise the risks of the credit bubble and slow to respond when the crisis hit. Others argue that the bank's relatively small capital base and wholesale funding model meant that it was almost impossible to avoid a loss of confidence when the turmoil struck.

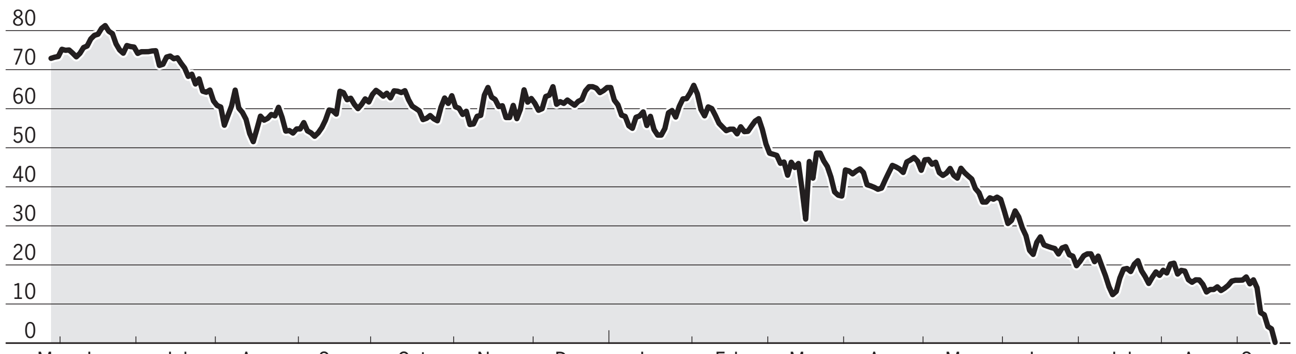
Strangely enough, it was presaged seven years ago by Mr Fuld himself. When asked, in an interview with the Financial Times, if Lehman's then $7.2bn in equity was sufficient for an investment bank, he responded with a story about playing blackjack in Las Vegas three decades before.

A young Lehman bond trader at the time, Mr Fuld said he was playing for a few dollars a hand when he was joined by a high-roller. The man's luck was terrible but every time he lost, he doubled his bet, impressing the younger Mr Fuld. "That's the answer," he thought. "Get enough capital and double up." But as dawn neared and the high-roller's losses mounted to several million dollars, Mr Fuld said he felt sick to his stomach as he realised the cost of taking a high-risk approach.

It does not matter how rich you are, Mr Fuld said. "You don't have enough capital." It is a lesson he has since had to relearn.

Loss of focus: the Archstone property deal was a sign that Lehman, led by Richard Fuld, was losing its touch Reuters

The long goodbye
Lehman Brothers share price ($)



Source: Thomson Datastream

Why a new Bretton Woods is vital – and so hard

By Martin Wolf
Published November 5 2008

We have arrived at the point in a crisis when ambitious leaders call for a "new Bretton Woods". It is easy to mock such language. Yet it is easy to see why this crisis should make people think in such heroic terms.

First, the world economy has come full circle, with a massive financial crisis emanating from the US, then and still the world's dominant financial power. The Great Depression of the 1930s was accompanied – and aggravated – by failures of economic co-operation, disintegration of the global economy and resurgent nationalism. But it also led to a revolution in economic thinking. "Never again" was the aim of the negotiators in Bretton Woods, New Hampshire. Mired in the worst financial crisis since the 1930s, we have good cause to say the same.

Second, it is unnecessary to wait for calmer times before thinking afresh. The Bretton Woods conference culminated in July 1944, while the second world war was far from over.

Third, today's global financial system is dysfunctional. What is at stake is maintenance of the open world economy that offers opportunities to so many. Also at stake is sustained co-operation among states. Nothing is less likely than effective co-operation among inward-looking states presiding over frightened, even xenophobic, societies.

Finally, what is happening lies at the intersection between global macroeconomics – money, the exchange rate and the balance of payments – and global finance: capital flows, financial fragility and contagion. The imperative of co-operation remains. But as Robert Zoellick, World Bank president, said on October 6: "We must modernise multilateralism and markets for a changing world economy."

So how is this to be done? We must start with the underlying challenges. The first is the inability to gain a purchase on the policies of countries that run huge and persistent current account surpluses. That was a dominant concern of John Maynard Keynes in 1944. Ironically, the problem then was US surpluses. Today, it is the collapse in the ability of US households and those of a few other high-income countries to offset the vast current account surpluses generated by China, Germany, Japan and oil-exporting countries. Surplus countries love criticising those who spend what they wish to lend. The former will soon discover they cannot do without the profligacy of the latter.

The second is that of financing countries subject to "sudden stops" in capital inflows of the kind we are seeing, as banks and other foreign-currency lenders cut off financing to a wide range of borrowers, particularly in emerging countries. Many of the latter have made an immense and costly effort to reduce vulnerability by accumulating foreign currency reserves. By August of this year, the total foreign currency reserves of emerging countries had reached $5,500bn, dwarfing the $260bn available to the International Monetary Fund. Yet self-insurance is inefficient and too unequally distributed.

The third challenge is that of making the financial system less unstable and, above all, less vulnerable to such huge swings in risk appetite – from financing anything, however ridiculous, to financing nothing, however meritorious. At present, moreover, as Stephen King of HSBC has pointed out on the FT's economists' forum, the efforts of governments to force rescued banks to finance domestic borrowers are bound to be at the expense of lending to emerging countries.

> The final challenge is that of making the global institutional architecture less illegitimate than today

The final challenge is that of making the global institutional architecture less illegitimate than today. The Bretton Woods institutions – the IMF and the World Bank – are dominated by the western powers: in the case of the IMF, the US still had 17.1 per cent of the quotas (which largely determine votes) and the European Union another 32.4 per cent in May 2007. Meanwhile, China had just 3.7 per cent and India 1.9 per cent. These are simply anomalous. So, too, is the persistence of the group of seven high-income countries as the co-ordinating group for the world economy, particularly as three of them – Germany, France and Italy – do not have independent currencies. The group of 20 looks too large. Mr Zoellick suggests a G14, which would add Brazil, China, India, Mexico, Russia, Saudi Arabia and South Africa.

What is interesting about this agenda is how familiar much of it would seem to the participants at Bretton Woods, with one exception. Keynes would be horrified that the world has let the genie of free capital flows out of the bottle. This, he would note, is why more external financing is needed than ever before, why vast foreign currency reserves have been accumulated and why financial crises are once again global, rather than local. He would add that "a sound banker, alas, is not one who foresees danger and avoids it, but one who, when he's ruined, is ruined in a conventional and orthodox way along with his fellows, so that no one can really blame him". We have far too many such bankers. He would surely add that these undercapitalised and illiquid institutions are little short of financial time-bombs.

Yet can anything useful be done to meet such challenges? It is certainly possible – and indeed necessary – to change the global architecture, not least in response to changing economic weights. It is equally necessary to give the IMF more financial resources in support of its new short-term lending facility. But it is surely too optimistic to believe that the IMF would ever be able to provide reliable warnings of looming crises. Even if it did, it is less likely the countries which matter would do anything.

Nor am I optimistic that we can sever the links connecting banking as a stodgy utility that provides essential services to the economy, to banking as a casino offering opportunities for taking huge bets. Bankers have been given a licence to gamble with taxpayers' money. That is a wonderful business to be in. It is one we seem unable to bring to heel.

Yet I wish to be proved wrong. What is happening now may well be the last chance for an open and dynamic world economy. First, we have to get through the present crisis. Then we have to have to make such catastrophic financial collapses vastly less likely. If not us, who? And if not now, when?

The economic forecasters' failing vision

By Chris Giles
Published November 25 2008

It has been a bad year for economic forecasters. So bad that royalty wants to know what went wrong. "Why did no one see it coming?" Britain's Queen Elizabeth asked during a visit to the London School of Economics this month.

Her Majesty's question has sparked a series of ludicrous claims about the prescience of individual forecasters.

"Although bankers with their fancy MBAs appear to have been dumbfounded by the financial crisis, regular attendees to Gresham College's free public lectures in central London were not," maintained one press release this month, citing a talk given in November 2002 by Avinash Persaud. But the lecture is as disappointing as the claims are inflated. "Despite record corporate bankruptcies, weak economies and a market meltdown, banks are generally safe," was Prof Persaud's conclusion.

Giulio Tremonti, Italy's finance minister, raised the predictive bar last week when he said Pope Benedict XVI was the first to foresee the crisis. A 1985 paper showed, according to Mr Tremonti, "the prediction that an undisciplined economy would collapse by its own rules".

Much closer to the truth was the more mundane assessment by Charlie Bean, the Bank of England's deputy governor, who noted that elements of the global economy had troubled lots of economists and policymakers for a long time. "We knew they were unsustainable and worried that the unwinding might be disorderly, though I don't think anyone could have guessed the course that events would actually take," he said.

There is no doubt that the credit crisis, which has morphed into recession across advanced economies, leaves most economic forecasters with ample egg on their studious faces. But policymakers, too, have reasons to cringe.

In his Senate nomination hearing of 2005, Ben Bernanke, the Federal Reserve chairman, said the US financial system had already benefited from a series of crises that had reinforced its ability to cope with difficult times. "The depths, the liquidity, the flexibility of the financial markets have increased greatly," he said.

Policymakers in Europe have had equal problems in foreseeing events. Jean-Claude Trichet, European Central Bank president, told four newspapers in mid-July: "Our baseline scenario is that we will have a trough in the profile of growth in the euro area in the second and third quarters of this year and, following this, a progressive return to ongoing moderate growth." Instead, Europe is staring at the biggest recession since the early 1990s.

Britain's nasty recession was not foreseen by Mervyn King, Bank of England governor. In May, he insisted: "It's quite possible that at some point we may get an odd quarter or two of negative growth. But recession is not the central projection at all."

International organisations, the great new hope of world leaders to provide an early warning of future problems, are just as fallible. The International Monetary Fund's spring 2007 forecast gushed at the success of the world economy. "Overall risks to the outlook seem less threatening than six months ago," its World Economic Outlook purred, in prose overseen by Simon Johnson, its then chief economist.

Among independent economists the record has been just as bad. The forecasts for growth compiled every month by Consensus Economics show a persistent move towards pessimism as Wall Street and City professionals catch up with events.

Even permanent bears did not see the full bursting of the credit bubble linked with the commodity boom. Nouriel Roubini, the global "Dr Doom" who got much of the crisis right, has also persistently revised his forecasts lower as the credit crunch has bitten harder.

The media cannot claim better foresight. While some commentators have found their predictions of crisis realised, none got the entire story right and many were lucky, having predicted 10 of the last two crises that eventually materialised. But others' luck does not diminish the embarrassment I feel when I read my own assessment from July that recession "might happen, but Britain is not there yet, and not even close". As everyone now knows, Britain was there, even at the time.

But more is to be gained by examining the particular failings that contributed to forecasters' general inability to warn of the current mess.

First is the unforeseen, but now evident, fragility of the global economy in the face of a systemic banking collapse. Jim O'Neill, chief economist of Goldman Sachs, says the failure of Lehman Brothers was "a game changer", before which his forecasts "were panning out OK" and after which "we have been scrambling to keep up".

Second, as Stephen King, chief economist of HSBC, says: "Almost all economic models assume that the financial system 'works'." Economists did not foresee how the looser monetary policy early in the decade could lead to an unprecedented credit expansion.

> Policymakers have been far from consistently wrong. Jean-Claude Trichet dines out on stories of how he predicted the crisis

Third was the deep squeeze on household and corporate incomes from the commodity boom of the first half of 2008, which almost no one predicted. This weakened the non-financial sector before banks had any chance to repair the damage from the subprime crisis and was a crucial element of the disaster that unfurled this autumn.

Fourth, most economic models suggest the demand for money will be stable, but banks and households have now begun to hoard cash. This threatens to make monetary policy ineffective as a tool for economic recovery, something that is not generally factored into forecasting models.

Fifth is an over-reliance on the output gap – the difference between the level of output and an estimate of what is sustainable – in forecasting. That allowed policymakers to believe all was fine, because inflation was under control and growth was not excessive.

Sixth is the natural tendency to seek rationales for events as they unfold, rather than question whether they are sustainable. Kenneth Rogoff, a Harvard professor and former IMF chief economist, thinks the tendency to look on the bright side is particularly prevalent on Wall Street, where "it is difficult to make a living as a mega-bear", he says.

Academics and the Fed also fell into the trap of rationalising unsustainable features of the global economy. In 2005 a paper by Ricardo Hausmann and Federico Sturzenegger of Harvard caused excitement about the possibility that financial "dark matter" would prevent a big bang in the world economy. The failure to believe in this dark stuff, the authors concluded, made "analysts predict crises that, for good reason, remain elusive".

Mention must also be given to the notable voices of doom who got important bits of the puzzle correct even if the timing or other details eluded them. Prof Roubini, who now runs the consultancy RGE Monitor, wrote a paper with Brad Setser in August 2004 predicting that the world's trade imbalances were unsustainable and likely to "crack the system in the next three to four years". He has been prescient in understanding the links between financial markets and the real economy.

William White, the former chief economist of the Bank for International Settlements, the central bankers' bank in Basel, Switzerland, was a persistent critic of lax monetary policy and the failure to stem credit expansion. Prof Rogoff also spotted the dangers of unsustainable global economic expansion in a 2004 paper with Maurice Obstfeld. In more recent work with Carmen Reinhart he has highlighted how policymakers fell into the "this time it's different" trap that dates back to England's 14th-century default.

Prof Persaud has made an honest living for many years warning about the fallibility of value-at-risk models and the tendency for them to encourage herd behaviour. And in the FT's new year survey of economists for 2008, Wynne Godley of Cambridge university, also a permanent bear, said: "I think the seizing up of financial markets may well result in a collapse in lending in the US to the non-financial sector so large that it causes a recession deeper and more stubborn than any other for decades – and deeper than anyone else is expecting." Quite.

Policymakers, too, have been far from consistently wrong. Mr Trichet dines out on stories of how he predicted the crisis and cites a Financial Times article as evidence that the warnings were not just the sort of throwaway remarks about risk that central bankers always give. Mr King warned for years about the risks evident in the global economy and the IMF repeatedly warned about the unsustainable level of house prices.

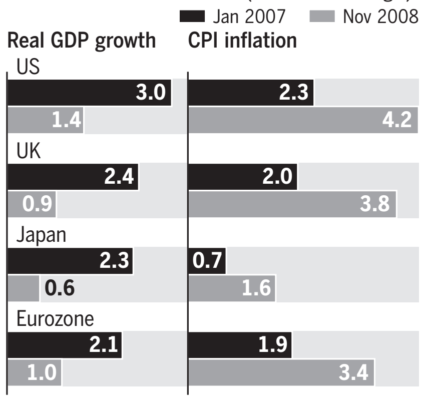
Willem Buiter, whose blog on FT.com was praised on Tuesday in parliament by the Bank of England governor, warns not to be too impressed by some forecasts that have turned out to be true, because they were lucky, not wise. "Hindsight is useless," Prof Buiter insists. "One has to look at the information available at the time and the arguments used at the time."

That is certainly valid and should form the basis of any judgment of forecasts or policy decisions taken. But it is also incumbent on the consumers of economic forecasts to be aware of what economic models can and cannot do. They should focus on the risks rather than purely the central forecasts.

Goldman's Mr O'Neill says private sector economists should try harder to under-promise and over-deliver. Despite all the talent and sophisticated models, they "didn't and couldn't have predicted the Lehman 'event'."

If only society had listened to the younger Cardinal Ratzinger more than 20 years ago – before, of course, it was reasonable to forecast he would be the next Pope.

Wide of the mark
Consensus forecasts 2008 (annual % change)



Source: Consensus Economics

Predictive models: blown off course by butterflies

In the 1980s, it seemed that computers held the key to economic forecasting. With large models and sufficient processing power, predictions would become more and more accurate.

This dream did not last long. We now understand that economies are complex, dynamic, non-linear systems in which small differences to initial conditions can make large differences to final outcomes – the proverbial flapping of a butterfly's wings that causes a hurricane.

So economic crystal ball-gazing remains unscientific. The trend is the forecaster's friend. Extrapolation assumes that the future will be like the past, only more so. We project current preoccupations – the rise of China and India, global terror, climate change – with exaggerated speed and to an exaggerated degree.

We forget that our preoccupations change. The people who worry about these issues today would 20 years ago have worried about the coming economic hegemony of Japan and the cold war. These issues were resolved in ways that few predicted.

It is a safe prediction – and the only one I shall make – that the topics that grab our attention 20 years from now will differ from those that consume us today and, if anyone has guessed what they are, it is only by accident. The future is unknowable. As Karl Popper observed, to predict the creation of the wheel is to invent it. To anticipate a new political force or economic theory, or even a new product, is to take the main step in bringing it into being.

If extrapolation is the forecaster's friend, mean reversion is the forecaster's crutch. Much of the time, you can predict that next year's figure will be somewhere between this year's level and the long-run average. But mean reversion never anticipates anything out of the ordinary. Every few years, out-of-the-ordinary things happen. They just have.

Still, you might think there would be large rewards for those who succeed in anticipating these events. You would be wrong. People who worried before 2000 that the "new economy" was a bubble, or warned of the terrorist threat before September 11 2001, or saw that credit expansion was out of control in 2006, were not popular. They were killjoys. Nor were they popular after these events. If these people had been right, then others had been blind or negligent, and the latter preferred to represent themselves as victims of unforeseeable events. As John Maynard Keynes observed, it is usually better to be conventionally wrong than unconventionally right.

John Kay

Broken banks put state back in driving seat

By Philip Stephens
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We are watching a bonfire of the old orthodoxies as well as of the vanities. This week Barack Obama promised to spend hundreds of billions of taxpayers' dollars to prop up the sinking US economy. Gordon Brown's British government announced it would soak the rich to pay for an economic rescue package.

In between times, the Bush administration all but nationalised Citigroup, the world's largest bank. For good measure it threw another, yes another, $800bn into the effort to thaw US credit markets. Everywhere you look, Keynes's demand management is replacing Adam Smith's invisible hand; printing money, a mortal sin under the fracturing Washington consensus, is the new prudence.

Something big is happening. What started out as a series of pragmatic ad hoc responses by governments and central banks is moving the boundary between state and market. Politicians are now overlaying expediency with ideology. Government is no longer a term of abuse.

Things could move still faster in the months ahead. With their myriad rescue schemes and loan guarantees, the US and British governments have nationalised their respective banking systems in all but name. The banks pretend they are still answerable to their shareholders, but it is a charade. They survive only with the explicit financial guarantee of the state.

Still, the markets remain frozen, starving business of the oxygen of credit. Unless things change soon, the politicians will have little choice but to take direct control, and quite possibly, ownership, of the banks. Nationalisation could be the first act of an Obama presidency. That at least would put some substance into all those loose analogies with FDR.

Either way, the simple fact that public ownership is viewed as a serious option – and Mervyn King, the governor of the Bank of England, said as much this week – tells you how far we have travelled from the liberal orthodoxies of recent decades. What was hailed as the new financial capitalism is making way for old-fashioned state direction. The politicians, meanwhile, are reclaiming language of that earlier age. Higher taxes on the wealthy are no longer taboo; regulation has been rehabilitated; markets can fail.

It seems only yesterday that the onward march of the Anglo-American model of liberal capitalism – small government, fiscal prudence, deregulation, flexible and open markets – set the shape and tempo of the global economy. Some European governments fought a long rearguard action against what one of my French friends calls the hyper-capitalism of the "Anglo-Saxons". But to a greater or lesser degree all made their accommodations.

In the US and Britain, the centre-left learned it could win elections only by accepting the Reagan-Thatcher settlement. Bill Clinton, a Democrat, wrote the requiem for big government.

In Britain, Tony Blair, aided and abetted by Mr Brown, built New Labour's electoral success on the promise that it was as much a friend of individual aspiration as of social justice. As proof, it promised never to raise the top rate of income tax from the 40 per cent set by the Thatcher government in the 1980s. As for markets, there was no one more scornful than Mr Brown of the continental European model of a more regulated social market capitalism.

That was then. This week Mr Brown said he intended to raise the top tax rate to 45 per cent. This would be the new dividing line with David Cameron's opposition Conservatives. The measure will raise only a fraction of the revenues needed to staunch the haemorrhaging of the nation's public finances. What matters is the political symbolism: for Mr Brown, fairness now trumps aspiration.

Until quite recently, it was possible to say that rescuing the financial system was calculated to save rather than sink liberal capitalism. As after past recessions, the system would survive the shock more or less intact.

To a degree the assumption still holds true. I have yet to see a politician climbing on to a soapbox to proclaim the ideological case for nationalising the banks. Mr Obama has promised a Rooseveltian strategy to rebuild America's infrastructure, but he is careful to talk about active not big government.

The leading members of Mr Obama's economic team were among the most enthusiastic apostles of liberal markets during the Clinton presidency. Main street America did not vote to throw out the capitalist baby with the bankers' bathwater.

Even as he tosses overboard the emblems of New Labour, Mr Brown, too, is wary of suggesting that government should take more control over the lives of ordinary voters. After a spate of bad headlines, Downing Street insists that higher taxes for the wealthy are an "extraordinary measure for extraordinary times". The caution is understandable. Voters want security against wild-west capitalism. They do not want to be smothered by the state.

For all that, the boundaries have moved. Busts always provoke a backlash. More often than not, all is forgotten in the subsequent upswing. But this time it is more than a bad hangover. The consequences of the crash of 2008 will be felt well beyond the eventual recovery.

For one thing, the banks are going to be under state administration, if not ownership, for a very long time. The old capitalism (and by that I mean the variety that until this year we called the "new" capitalism) was predicated on a financial system that created an endless supply of cheap credit. It will take more than a cyclical upturn before politicians again allow banks to manufacture money on such an epic scale.

That will demand deep structural adjustments in economies kept afloat on the sea of credit. The US, Britain and the other boom-to-bust economies will find the world no longer willing to finance their domestic housing and borrowing booms. Voters, meanwhile, will absorb the message that it is no longer a self-evident truth that ever more liberal markets deliver painless prosperity.

The risk is that the recalibration will go too far: that innovators and entrepreneurs will be put in the stocks with investment bankers; and that fettered markets at home will be accompanied by protectionism abroad. Lest we forget, for all its flaws, a liberal trading system has delivered hundreds of millions of people from abject poverty.

The market has lost its magic, but we do not know whether Mr Obama can properly rehabilitate government. So the shape of a new settlement is far from clear. What is certain is that things cannot be as they were.

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